

Franchise Tax BoardAuthor: Corbett Analyst: John Pavalasky Bill Number: AB 2442Related Bills: See Legislative History Telephone: 845-4335 Introduced Date: 02/24/2000Attorney: Patrick Kusiak Sponsor: _____**SUBJECT:** Exclusion/50% of Gain From Sale Of Qualified Small Business Interests Held for More than 5 YearsSUMMARY

Under the Personal Income Tax Law, this bill would expand the current law exclusion of 50% of the gain on the sale of qualified small business stock of a C corporation from gross income to also apply to the sale or exchange of interests held in other types of small business entities, such as partnerships, limited liability companies (LLCs), S corporations and any unincorporated qualified small business.

EFFECTIVE DATE

This bill is a tax levy and would be effective immediately upon enactment and be operative for taxable years beginning on or after January 1, 2000. By its terms, it would apply to interests in unincorporated qualified small businesses that are originally issued, formed, or created after January 1, 2001.

LEGISLATIVE HISTORY

SB 671 (Ch. 881, Stats. 1993) enacted the 50% capital gain exclusion for small business stock; SB 1805 (Ch. 1243, Stats. 1994) codified act language from SEC. 28 of Senate Bill 671 (Stats. 1993, Chapter 881), relating to application of federal regulations to California's "stand alone" provision for the 50% exclusion; SB 715 (Ch. 952, Stats. 1996) adopted the federal tax law definition of "domestic corporation" (a corporation created or organized in the U.S. or any state) and also made technical, nonsubstantive changes that merely eliminated superfluous language; and AB 1120 (Ch. 69, Stats. 1999) removed the January 1, 1999, sunset date for the 50% exclusion. AB 1783 (99/00) would increase to 100% the exclusion of gain on the sale of qualified small business stock purchased after the effective date of the bill and held for more than five years.

SPECIFIC FINDINGS

Under both federal and California law, noncorporate investors may exclude from gross income 50% of the gain realized and recognized on the sale or exchange of qualified small business stock that has been held for more than five years. Below is a summary of the qualification rules. (See attachment 1 for the detailed rules.) The amount that a taxpayer may exclude as gain with respect to qualified small business stock issued by the same issuer is limited to the greater of \$10 million (\$5 million for married individuals filing separate returns) or 10 times the taxpayer's original basis in the stock of the issuing corporation.

Board Position:

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Department Director

Date

Alan Hunter for GHG

4/4/00

To qualify as small business stock for federal purposes, the stock must be that of a "C" corporation. The total gross assets (treating all members of the same parent-subsidiary controlled group as one corporation) of the corporation at all times after August 10, 1993, and before the date of issuance, as well as immediately after the date of issuance, must not exceed \$50 million.

The corporation must meet certain reporting requirements. During substantially all of the taxpayer's holding period for the stock, the corporation (other than certain excluded corporations) must meet an active business test. The taxpayer claiming the exclusion must have acquired the stock when the stock was originally issued for money or other property (not including stock) or as compensation for services provided to the corporation.

To qualify as California qualified small business stock and thus be eligible for the exclusion under California law, the issuer must meet the following additional rules:

1. Must be doing business in California at all times on or after July 1, 1993;
2. Must have assets of \$50 million or less, when measured as a controlled group using modified federal rules, before the issuance of the stock; and
3. Must have at least 80% of the total dollar value of its payroll attributable to employment located in California.

For both federal and California purposes, one-half of the amount of gain excluded is treated as a preference item under the alternative minimum tax (AMT).

An information return is to be filed with the Franchise Tax Board by the small business within 30 days after an eligible investment in the qualifying small business has been made.

This bill, under the Personal Income Tax Law, would expand the current law exclusion of 50% of the gain on the sale of qualified small business stock of a C corporation to apply to the sale or exchange of interests held in other types of small business entities such as partnerships, LLCs, S corporations and any unincorporated qualified small business.

This bill defines "other qualified small business interests" to mean any interest in a partnership or LLC, any stock in an S corporation and any interest in an unincorporated qualified small business that is originally issued, formed, or created after January 1, 2001, **provided that the interest would qualify under the current law exclusion if it were stock in a C corporation.** However, in making the determination, provisions in current law which are only relevant to C corporations and have no counterpart in the context of these other types of interests are not to be taken into account.

Policy Considerations

Unlike the present small business stock provisions, this bill does not treat one-half of the excluded gain as a preference item for alternative minimum tax. This difference provides a greater tax benefit for the types of interests contained in this bill than that provided under current law for the sale of qualified small business stock in a C corporation.

This bill does not require an information return to be filed with the Franchise Tax Board by the small business within 30 days after an eligible investment in the qualifying small business has been made as under current law for an eligible investment made in a qualifying C corporation. In addition to making it more difficult for the department to verify the original owner of the qualified small business interest, the lack of a reporting requirement would also limit the information available if the Legislature wishes to assess the incentive effect or potential future cost of this incentive if it should later be interested in doing so.

Implementation Considerations

The use of a qualification standard for an interest to qualify under this bill, **"provided that the interest would qualify under the current law exclusion if it were stock in a C corporation,"** would likely result in disagreements between investors and small businesses on the one hand and the department on the other to determine with any degree of confidence that the conclusion would be upheld by the courts. Making this determination would be especially difficult because the bill provides that in making the determination, provisions in current law that are relevant only to C corporations and have no counterpart in the context of these other types of interests, are not to be taken into account.

It would be far preferable from both a certainty standpoint for investors and an audit standpoint for the department for the bill to specifically identify those rules necessary to adapt current law specifically to each type of interest in each small business entity specified in the bill. That would enable each investor, small business entity issuer, and the department to know the specific qualification requirements for the exclusion.

It is unclear how the special rules in the current law small business stock regime specifying the tax result under that section when qualified small business stock is exchanged in a transaction in which gain is realized, but not recognized (for example, a tax-free reorganization), would be applied under this bill, especially if a qualified small business interest were to be exchanged for qualified small business stock. For example, since under the small business stock provisions only money or property other than stock may be used to purchase qualified small business stock, a taxpayer who held a qualified small business interest under the provisions of this bill for 10 years, and then exchanged it in a tax-free transaction for small business stock, would literally not be entitled to receive the benefits provided under this bill nor would the stock received qualify as qualified small business stock. Similar interpretive problems may arise in trying to integrate the two separate provisions if further legislative clarification is not forthcoming.

Technical Considerations

On page 2 of the bill on line 6, the word "and" should be replaced with the word "any."

FISCAL IMPACT

Departmental Costs

Assuming that the implementation concerns are resolved, the department would not expect to incur significant administrative costs.

Tax Revenue Estimate

Based on the current level of venture capital funding and limited information from federal sources regarding the current law exclusion, it is projected that state revenue losses under the Personal Income Tax Law from extending the 50% exclusion to gains from interests in other business forms would be as follows over the initial years:

Estimated Revenue Impact of AB 2442 As Introduced 2/24/00 [\$ In Millions]		
2005-06	2006-07	2007-08
-\$2	-\$25	-\$30

It should be noted that if federal law were changed to include these other business types, state revenue losses would be larger.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The amount of qualified gains reported starting in 2006 times the average marginal tax rate would determine the revenue impact of this bill.

Venture capital funding in the U.S. reached \$48 billion for 1999 with investments in California comprising approximately one-third. Around one-half of investment dollars nationally were in Internet-related activities and e-commerce. Future investment levels are highly speculative. Not all businesses qualify investors for the current 50% state exclusion because of specific industry, asset, and employment tests. Based on conversations with federal estimators at the Office of Tax Analysis (Treasury Department), while it is not known what the typical holding period is for investors in C corporations, it would likely be significantly less for other business entities because the probability of early acquisition by other companies is greater.

Revenue estimates above follow the basic methodology used to estimate current state law impacts for the C corporation exclusion and allow for the AMT interaction. These estimates assume total venture capital investment in California businesses, other than C corporations, at the \$9 billion level for 2001 and projected qualified exclusions of \$300 million for the 2006-07 revenue estimate. There would be a relatively minor impact for 2005-06 as indicated.

BOARD POSITION

Pending.

ATTACHMENT 1

In order for stock held by a taxpayer to qualify as small business stock for California law, the following requirements must be met.

Eligible stock and redemptions

The stock must be acquired by the taxpayer at the original issuance (directly or through an underwriter) in exchange for money, other property (not including stock) or as compensation for services provided to the issuing corporation (other than services performed as an underwriter of the stock).

In order to prevent evasion of the requirement that the stock issuance generates new capital for the issuing corporation, the exclusion does not apply if the issuing corporation (1) purchases any stock from the stockholder (or a related person) within two years of the issuance of the stock or (2) redeems more than 5% (by value) of its own stock within one year of the issuance. For purposes of this anti-evasion rule, a corporation is treated as purchasing an amount of its stock equal to the amount of its stock treated as redeemed under Section 304(a) of the Internal Revenue Code.

Qualified issuer

The issuing corporation must be a qualified small business as of the date of issuance and during substantially all of the period that the taxpayer holds the stock.

A qualified small business is a subchapter C corporation **other than:** a domestic international sales corporation (DISC) or former DISC, a corporation with respect to which an election under Section 936 is in effect (Possession Corporation), a regulated investment company (RIC commonly called a mutual fund), a real estate investment trust (REIT), a real estate mortgage investment conduit (REMIC), or a cooperative. The provision excludes from the definition of eligible corporation any corporation that has a direct or indirect subsidiary with respect to which an election under Section 936 of the Internal Revenue Code is in effect. The corporation also generally cannot own (i) real property the value of which exceeds 10% of its total assets or (ii) portfolio stock or securities the value of which exceeds 10% of its total assets in excess of liabilities.

Active business

During substantially all of the taxpayer's holding period for the stock, at least 80% (by value) of the corporation's gross assets (including intangible assets) must be used by the corporation in the active conduct of a qualified trade or business in California. If in connection with any future qualified trade or business, a corporation uses assets in certain start-up activities, research and experimental activities or in-house research activities, the corporation is treated as using such assets in the active conduct of a qualified trade or business.

The active business requirement is met by a corporation with 80% of its assets used in the active conduct of one or more qualified trades or businesses. In order to satisfy the active business requirement, at least 80% of the corporation's payroll expense must be attributable to employment located within California.

Assets that are held to meet reasonable working capital needs of the corporation, or are held for investment and are reasonably expected to be used within two years to finance future research and experimentation, are treated as used in the active conduct of a trade or business. In addition, certain rights to computer software are treated as assets used in the active conduct of a trade or business.

A corporation that is a specialized small business investment company (SSBIC) is treated as meeting the active business test. An SSBIC is defined as any corporation (other than certain nonqualified corporations) that is licensed by the Small Business Administration under Section 301(d) of the Small Business Act of 1958, as in effect on May 13, 1993.

Qualified trade or business

A qualified trade or business is any trade or business **other than** one involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its employees. **The term also excludes** any banking, insurance, leasing, financing, investing, or similar business, any farming business (including the business of raising or harvesting trees), any business involving the production or extraction of products of a character for which percentage depletion is allowable, or any business of operating a hotel, motel, restaurant or similar business.

Gross assets and California payroll

As of the date of issuance of the stock, the excess of (1) the amount of cash and the aggregate adjusted bases of other property held by the corporation, over (2) the aggregate amount of indebtedness of the corporation that does not have an original maturity of more than one year (such as short-term payables), cannot exceed \$50 million. For this purpose, amounts received in the issuance are taken into account. The \$50 million size limitation is based on the issuer's gross assets (i.e., the sum of the cash and the adjusted bases of other property held by the corporation) without subtracting the short-term indebtedness of the corporation. For purposes of this rule, the adjusted basis of property contributed to the corporation is determined as if the basis of the property immediately after the contribution were equal to its fair market value. Also, at least 80% of the small business' payroll (measured by total dollar value) must be attributable to employment located within California.

If a corporation satisfies the gross assets test as of the date of issuance but subsequently exceeds the \$50 million threshold, stock that otherwise constitutes qualified small business stock would not lose that characterization solely as a result of that subsequent event.

If a corporation (or a predecessor corporation) exceeds the \$50 million threshold at any time after December 31, 1992, the corporation cannot issue stock that would qualify for the exclusion.

Subsidiaries of issuing corporation

In the case of a corporation that owns at least 50% of the vote or value of a subsidiary, the parent corporation is deemed to own its ratable share of the subsidiary's assets for purposes of the "qualified corporation," "active business," and "gross assets" tests described above. Corporations that are part of a parent-subsidiary controlled group (using a more than 50% ownership test) are treated as a single corporation for purposes of the gross assets test.

Pass-through entities

Gain from the disposition of qualified small business stock held by a partnership, S corporation, regulated investment company or common trust fund that is taken into account by a partner, shareholder or participant (other than a C corporation) is eligible for the exclusion, provided that (1) all eligibility requirements with respect to qualified small business stock are met, (2) the stock was held by the entity for more than five years, and (3) the partner, shareholder or participant held its interest in the entity on the date the entity acquired the stock and at all times thereafter and before the disposition of the stock. In addition, a partner, shareholder, or participant cannot exclude an amount of gain recognized by the pass-through entity that exceeds the partner's, shareholder's, or participant's interest in the entity at the time the entity acquired the stock.

Certain tax-free and other transfers

If qualified small business stock is transferred by gift or at death, the transferee is treated as having acquired the stock in the same manner as the transferor, and as having held the stock during any continuous period immediately preceding the transfer during which it was held by the transferor. A partner can treat stock distributed by a partnership as qualified small business stock as long as (1) all eligibility requirements with respect to qualified small business stock are met by the partnership with respect to its investment in the stock, and (2) the partner held its interest in the partnership on the date the partnership acquired the stock and at all times thereafter and before the disposition of the stock. In addition, a partner cannot treat stock distributed by a partnership as qualified small business stock to the extent that the partner's share of the stock distributed by the partnership exceeded the partner's interest in the partnership at the time the partnership acquired the stock.

Transferees in other cases are not eligible for the exclusion. Thus, for example, if qualified small business stock is transferred to a partnership and the partnership disposes of the stock, any gain from the disposition will not be eligible for the exclusion.

In the case of certain incorporations and reorganizations where qualified small business stock is transferred for other stock, the transferor treats the stock received as qualified small business stock. The holding period of the original stock is added to that of the stock received. However, the amount of gain eligible for the exclusion is limited to the gain accrued as of the date of the incorporation or reorganization. This limitation does not apply in the case where the stock received in the incorporation or reorganization was itself qualified small business stock.

Special basis rules

If property (other than money or stock) is transferred to a corporation in exchange for qualified small business stock, the basis of the qualified small business stock received is treated as not less than the fair market value of the property exchanged for purposes of computing the amount of any future gain eligible for the 50% exclusion. Thus, only gains that accrue after the transfer are eligible for the exclusion.

Options, nonvested stock, and convertible instruments

Stock acquired by the taxpayer through the exercise of options or warrants, or through the conversion of convertible debt, is treated as acquired at original issue. The determination whether the gross assets test is met is made at the time of exercise or conversion, and the holding period of such stock is treated as beginning at that time.

In the case of convertible preferred stock, the gross assets determination is made at the time the convertible stock is issued, and the holding period of the convertible stock is added to that of the common stock acquired upon conversion.

Stock received in connection with the performance of services is treated as issued by the corporation and acquired by the taxpayer when included in the taxpayer's gross income in accordance with the rules of Section 83 of the Internal Revenue Code.

Offsetting short positions

A taxpayer cannot exclude gain from the sale of qualified small business stock if the taxpayer (or a related person) held an offsetting short position with respect to that stock anytime before the five-year holding period is satisfied.

If the taxpayer (or a related person) acquires an offsetting short position with respect to qualified small business stock after the five-year holding period is satisfied, the taxpayer must elect to treat the acquisition of the offsetting short position as a sale of the qualified small business stock in order to exclude any gain from that stock.

An offsetting short position is defined to be (1) a short sale of property substantially identical to the qualified small business stock (including writing a call option that the holder is more likely than not to exercise or selling the stock for future delivery) or (2) an option to sell substantially identical property at a fixed price.

Capital gains and investment interest

Any gain that is excluded from gross income is not taken into account in computing long-term capital gain or in applying the capital loss rules of Sections 1211 and 1212 of the Internal Revenue Code.

The amount treated as investment income for purposes of the investment interest limitation does not include any gain that is excluded from gross income.

Minimum tax

One-half of any excluded gain is treated as a preference item for purposes of the alternative minimum tax.

Information return

An information return is to be filed with the Franchise Tax Board by the small business within 30 days after an eligible investment in the qualifying small business has been made.